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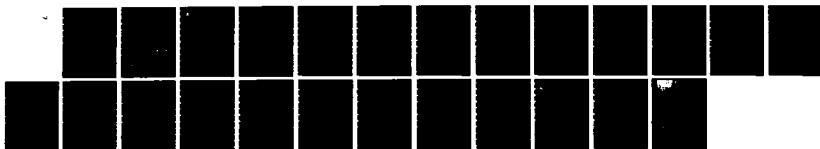
EXCESS NAVY SHIPS SOLD TO FOREIGN COUNTRIES AT
UNDERSTATED PRICES(U) GENERAL ACCOUNTING OFFICE
WASHINGTON DC NATIONAL SECURITY AND INTERNATIONAL
AFFAIRS DIV 12 APR 84 GAO/NSIAD-84-7

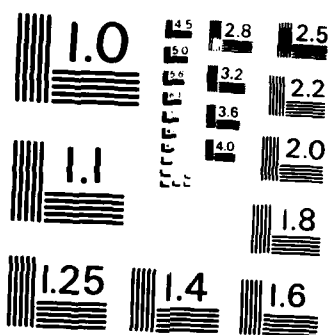
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BY THE U.S. GENERAL ACCOUNTING OFFICE
Report To The Secretary Of Defense

Excess Navy Ships Sold To Foreign Countries At Understated Prices

Each of the 11 ships sold to foreign countries in fiscal years 1981 and 1982 was underpriced according to the Navy's guidance. The ships were sold for a total of \$5.2 million, whereas prices should have totaled \$36.4 million.

The prices were generally based on scrap value rather than the higher fair value. This value could be even greater, but the condition of the ships was not adequately determined. In addition, some conversion and overhaul costs were not charged as required, and many spare parts and other supplies were left on board at no cost to the recipients.

According to Navy officials, there are often political and diplomatic considerations and pricing precedents that the Office of the Chief of Naval Operations perceives as outweighing approved pricing methods.

The Navy has taken some corrective actions and is determining whether changes to policies are required. However, Defense does not agree with GAO that it provide Congress with more pricing information for certain ships which are to be sold.

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UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

NATIONAL SECURITY AND
INTERNATIONAL AFFAIRS DIVISION

B-165731

The Honorable Caspar W. Weinberger
The Secretary of Defense

Dear Mr. Secretary:

We reviewed the Navy's policies and procedures for selling excess ships to foreign countries and found that the 11 ships sold during 1981 and 1982 were underpriced according to the Navy's instructions. (See app.I.)

Prices were generally based on scrap value rather than the higher fair value called for in Navy guidelines. By using scrap value to set prices for eight of the ships, the Navy did not

- include conversion costs (the amount spent to upgrade and modernize the ships during their service years),
- charge overhaul costs to foreign countries,
- determine the ships' condition at the time of sale, or
- include the cost of incidentals, such as spare and repair parts, fuel, and consumables.

In 1982, the Navy altered its pricing computations to require use of fair or scrap value, whichever is higher. However, in the three cases in which fair value was used, conversion and incidental costs were excluded from the sales price.

If the Navy had correctly computed fair value and charged the appropriate costs for these sales, then the prices would have totaled about \$36.4 million rather than the \$5.2 million actually charged. (See app. II.) Thus, the U.S. government provided \$31.2 million through these sales in what is tantamount to grant foreign assistance.

According to Navy officials, there are often political and diplomatic considerations and pricing precedents that the Office of the Chief of Naval Operations perceives as outweighing approved pricing methods. They noted that since World War II the ship transfer program has been an integral part of the U.S. security assistance program which is designed to support this nation's foreign policy objectives.

The Navy guidelines implement a statutory requirement (Section 21 of the Arms Export Control Act) that ships be sold at their "actual value." We recognize in certain instances that national security interests might justify selling a ship below its actual value. However, the decision to sell a ship at a lower price does not rest with the Navy. If the Navy proposes, for whatever reason, to charge a price less than the actual value of a ship, we believe it must request specific legislation authorizing such a lower price from the appropriate congressional committees.

10 U.S.C. §7307 requires specific enabling legislation to sell a ship less than 20 years old or displacing more than 3,000 tons. We believe that when the Navy requests specific authorization to sell a ship under 10 U.S.C. §7307, the proposed sale price it reports to the Congress should be based on the higher of scrap or fair value. If the Navy, however, proposes to sell the ship for less than this amount, the sale price, how it was calculated, and justification for that price should be reported. Congress then would have adequate information to determine what value it would require for the sale of the ship.

We recommend that you require that the Secretary of the Navy:

- Adhere to the established pricing instructions, which require pricing ships at the higher of fair value or scrap value. Specifically, when computing the sale price for ships being sold to foreign countries, the Navy should include conversion costs to determine fair value.
- Provide the Congress, for ship sales which according to 10 U.S.C. §7307 require specific legislation, with information on (1) a proposed sale price based on the higher of scrap or fair value and (2) Navy proposals to sell the ship for less than this amount, how this was calculated, and the justification for the proposed sale price.

In addition, we recommend that you direct the Secretary of the Navy to revise Navy pricing guidance to require that:

--The Board of Inspection and Survey, in addition to determining whether a ship is fit or unfit for further U.S. Navy service, also determine the ship's overall condition. The Chief of Naval Operations should use this determination in deciding what fair value rate to apply in computing the fair value price.

--Ship overhaul costs be prorated based on their recommended schedule for overhaul and such prorated costs be included in the sale price.

We obtained comments from the Departments of State and Defense through the Defense Security Assistance Agency and Navy officials responsible for ship transfers. Defense agreed with some aspects of our report and said the Navy has taken some corrective actions and is revising instructions and reviewing others to determine if policy changes are necessary. We have modified the report to (1) recognize that the Navy altered its pricing policy to require that ships may be sold at the higher of scrap or fair value, (2) show that the Navy has updated the factors for computing scrap value, and (3) clarify who determines the condition of ships. Other changes were proposed by the Navy and, where appropriate, are reflected in this final report.

With respect to our conclusion that if the Navy proposes to sell a ship weighing 3,000 tons or less or 20 or more years old for less than its actual value, specific legislation authorizing the sale at the lower price would be required, DOD stated that specific legislation is unnecessary since it is now its policy to sell ships for their actual value.

Additionally, Defense did not agree with our recommendation that Congress be provided with more pricing information for ships requiring specific legislation to be sold (i.e., more than 3,000 tons or less than 20 years old). It stated that the procedures by which those ships are priced are already subject to hearings/review by four congressional committees. While the Navy has taken steps to improve the pricing of excess ships to ensure that the ships are sold at the higher of scrap or fair value, we believe that in seeking legislative authorization to sell a ship, the Navy should specifically disclose to the Congress either that the proposed sales price is the higher of scrap or fair value or on what basis the proposed sales price was calculated.

As you know, 31 U.S.C. § 720 requires the head of a federal agency to submit a written statement on actions taken on our recommendations to the Senate Committee on Governmental Affairs and the House Committee on Government Operations not later than 60 days after the date of this report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

We are sending copies of this report to the Director, Office of Management and Budget; the Secretary of State; the cognizant congressional appropriations and authorizations committees; and others upon request.

Sincerely yours,

A handwritten signature in dark ink, appearing to read "Frank C. Conahan". The signature is fluid and cursive, with the first name "Frank" and last name "Conahan" clearly distinguishable.

Frank C. Conahan
Director

C o n t e n t s

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ABBREVIATIONS

DOD
GAO

Department of Defense
General Accounting Office



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Unannounced	<input type="checkbox"/>
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EXCESS NAVY SHIPS SOLD TO
FOREIGN COUNTRIES AT UNDERSTATED PRICES

Ships stricken from the Naval Vessel Register can be sold to foreign countries under provision of the Arms Export Control Act. Section 21 of the Act authorizes sales of defense articles and services to foreign countries and international organizations.

Navy officials indicated that ships are typically found unfit for further service in the U.S. Navy because they are obsolete or no longer meet mission requirements. However, these ships may be useful in facing less capable regional military threats or for coastal policing and patrolling duties against smuggling or similar domestic civilian duties of our allies. Additionally, they are also used for spare parts.

The Navy informed us that most of the ships sold during 1980 through 1982 are still in active service in the foreign countries. A few of the ships are inactive and are being used for spare part support.

The Director, Security Assistance Division, Office of the Chief of Naval Operations (OP-63), coordinates Navy ship sales. Excess ships are normally sold on an "as is, where is" basis, and title passes to the recipient on transfer. All sales are made only after satisfying the congressional oversight provisions of 10 U.S.C. § 7307. This law requires specific enabling legislation for ships less than 20 years old or displacing more than 3,000 tons. For all other naval vessels, the law requires notification to the Congress.

The 11 ships sold in 1981 and 1982 were Gearing class destroyers and sold subsequent to congressional notification. Five of the 11 ships were hot ship transfers¹ and the remaining 6 were sold from the inactive fleet. (See app. III.)

PRICING: SCRAP VERSUS FAIR VALUE

Most ships sold in 1981 and 1982 were underpriced because the Navy sold them at scrap value instead of the higher fair value.² In 1982, the Navy altered its pricing computations to

¹A hot ship transfer consists of turning over a ship to a foreign country on the day the vessel is retired from the U.S. Navy. This eliminates inactivation costs to the U.S. Navy and activation costs to the foreign government.

²Fair value is the original acquisition cost of a ship plus any modernization/conversion costs and multiplied by a fair value rate based on the condition code.

ensure that ships are priced at the higher of scrap or fair value. The Navy sold three ships in October and December 1982 based on the revised pricing policy using fair value; however, even these ships were underpriced because not all conversion costs were included.

Ships sold subsequent to congressional notification and pursuant to the Arms Export Control Act must be priced according to section 21 of the Act, which requires that a ship be sold for its "actual value." The Foreign Military Sales Financial Management Manual (Department of Defense 7290.3-M) implements this legal requirement by establishing a "selling price" as the higher of either market value (scrap value) or fair value. Scrap value is developed from historical trends of scrap values paid per light ton for various ship classes. Fair value is determined by adding the original acquisition cost of the ship and any conversion costs and multiplying the total by the fair value rate. This rate is a percentage representing the condition of the ship at the time of sale. The fair value rate ranges from 5 percent (an unserviceable ship requiring major repairs) to 50 percent (a ship in excellent condition).

Since section 21 of the Arms Export Control Act requires ships to be sold at not less than "actual value", if the Navy wishes to sell for less than this amount, specific authorizing legislation is required.³ However, for ships 3,000 tons or less or 20 or more years old priced by the Navy at actual value, the Navy is only required to notify the House and Senate Armed Services Committees prior to the sale. Sales at less than actual value, we believe, involve price subsidies that are tantamount to grant military assistance to the recipient countries. As such, the Congress--not the Navy--should make the sales and pricing decision.

According to Navy officials, there are often political and diplomatic considerations and pricing precedents that the Office of the Chief of Naval Operations perceives as outweighing approved pricing methods. They noted that since World War II the ship transfer program has been an integral part of the U.S. security assistance program which is designed to support this nation's foreign policy objectives. Part of the rationale for the program is that ships which may be of little use to the

³Alternatively, the President can waive the requirement that a ship be sold at its "actual value" by determining, under authority of section 614(a)(2) of the Foreign Assistance Act, as amended, that such waiver "is vital to the national security interests of the United States" and so notifying the Speaker of the House and the Chairman of the Senate Foreign Relations Committee.

United States are of great value to our allies, and also contribute to the U.S. defense, strengthen mutual defense agreements, and are visible reminders of friendly alignments.

We found that generally ships are sold because of requests from foreign countries or as a result of defense cooperation agreements or other agreements made by the Departments of State and Defense. For example, the Cone was sold to Pakistan in October 1982 as part of a previous agreement that six ships would be provided as soon as they became excess to U.S. Navy needs. The Johnston was sold to Taiwan in February 1981, as a result of an agreement with the American Institute of Taiwan, to be used to support several ships of the same class previously transferred. Additionally, the McKean was provided to Turkey as part of the Defense Cooperation Agreement and was sold at scrap value rather than market value because of the advanced state of negotiations with the Turkish government.

When such factors arise, the manual provides that deviations to pricing policies may be granted by the Chief of Naval Operations where consistent with statutory requirements and in the best interest of the U.S. government. However, whatever pricing policy is approved by the Chief of Naval Operations, it must meet the statutory criterion of section 21 of the Arms Export Control Act that it represent the ship's "actual value."

Eight of the 11 ships which the Navy sold in 1981 and 1982 were sold at scrap value. If fair value had been used, the total prices would have increased by about \$5.7 million, as shown below.

Ship	Price based on fair value	Actual sale price based on scrap value	Difference
Johnston (DD 821)	\$912,266	\$286,000	\$626,266
N.K. Perry (DD 883)	942,671	286,000	656,671
Corry (DD 817)	1,134,469	286,000	848,469
Dyess (DD 880)	988,293	286,000	702,293
Rogers (DD 876)	1,026,388	296,010	730,378
Steinaker (DD 863) ^a	1,125,431	376,350	749,081
Vogelgesang (DD 862)	1,023,490	376,350	647,140
McKean (DD 784) ^a	1,133,443	357,410	776,033
	<u>\$8,286,451</u>	<u>\$2,550,120</u>	<u>\$5,736,331</u>

^aDeviations for sale at less than actual value were requested from the Chief of Naval Operations for both the Steinaker and the McKean. For example, the McKean was sold at the scrap value because of a commitment to the Turkish government.

The following example shows the difference between the use of scrap value versus fair value in determining the price for a ship. This example is typical of the other ships sold at scrap value in 1981 and 1982.

EXAMPLE: Steinaker (DD 863) Sold In
February 1982 To Mexico For \$376,350

ACTUAL SALE PRICE
BASED ON SCRAP VALUE

Scrap value	\$349,638
Administrative and other costs	<u>26,712^a</u>
Total	<u>\$376,350</u>

PRICE BASED ON
FAIR VALUE

Acquisition cost	\$ 8,502,927
Conversion costs	<u>12,408,101</u>
	20,911,028
Fair value rate	<u>.05^b</u>
	1,045,551
Administrative and other costs	<u>79,880^a</u>
Total	<u>\$ 1,125,431</u>

^aStandard percentage rates are applied to the price to cover nonrecurring research and development costs, contract administration costs, asset use charges, and expenses of sales negotiations, accounting, etc.

^bThe fair value rate is based on the condition of the ship. Since the Navy does not adequately determine the condition of ships to be transferred, we used the lowest rate that can be applied.

The Navy sold the remaining three ships on the fair value basis. However, contrary to the requirement of the Navy Comptroller Manual, not all conversion costs to upgrade and modernize these ships were applied because the Navy considered the conversions to be minor. The Navy did not include conversion costs for the Cone (DD 866), Hollister (DD 788), and Hawkins (DD 873) of \$1,772,150, \$50,614, and \$1,822,347 respectively, in determining the fair value price for these three ships. As shown below, the prices would have increased by at least \$182,256 if these conversion costs had been included in determining fair value.

<u>Ship</u>	<u>Conversion costs</u>	<u>Lowest fair value rate</u>	<u>Amount not included in sale price</u>
Cone	\$1,772,150	5%	\$ 88,608
Hollister	50,614	5%	2,531
Hawkins	1,822,347	5%	<u>91,117</u>
			<u>\$182,256</u>

In commenting on our draft report, Navy officials said that through administrative error, conversion costs were not included. To correct this, steps have been taken to preclude future errors, and current instructions have been revised and will be revised on March 30, 1984, to insure that this policy is clearly stated.

FORMULA FOR DETERMINING
SCRAP VALUE WAS OUTDATED

The Navy's formula for determining scrap value has not been revised since it was established 10 years ago. Therefore, when the Navy sells a ship at scrap value, the ship may be underpriced because the accuracy of the formula has not been fully determined. The Navy initiated a review over a year ago to compare the estimated scrap sale value of 500 U.S. Navy ships with their actual sales prices.

The Navy determines scrap value by multiplying a ship's weight, a scrap index, and a scrap factor. The scrap index is supplied by the Bureau of Labor Statistics and represents the "Pittsburgh #1 Heavy Melting" index for scrap metals. The scrap index fluctuates monthly and, therefore, scrap value fluctuates monthly.

There are six scrap factors, each representing a different class of ship. These factors were calculated approximately 10 years ago by Navy personnel. The scrap factors vary because different ships contain different amounts of usable metals. The factors also vary because of different structures on different classes of ships. We were not able to verify the validity of the scrap factors because the Navy did not have documentation. Navy officials in commenting on our draft report indicated that their study has been completed and the scrap factors have been updated to reflect the current scrap value.

CONDITION OF SHIPS NOT
ADEQUATELY DETERMINED

A ship's condition at the time of sale determines what fair value rate will be applied to the inventory price in arriving at fair value. The rate ranges from 5 to 50 percent.

In the three cases where fair value was used, the Office of the Chief of Naval Operations applied the lowest rate, or 5 percent, primarily because the Navy's Board of Inspection and Survey had made a decision that each ship was unfit for further U.S. Navy service. We were informed by Navy officials, however, that there is not necessarily a direct relationship between a determination of "fit" or "unfit" for further service and a ship's condition. Board personnel told us that, with little or no work, they could determine the overall condition.

As an example, we found that Navy records indicated that the Cone was in good condition when it was sold to Pakistan. This ship was overhauled 22 months prior to its sale. In addition, the inspection team from the Board determined that the ship was fit for further U.S. Navy service and recommended that it be retained in the Naval Reserve Force but this recommendation was overridden at a higher level. If the Cone had been valued at even a 10-percent fair value rate, rather than 5 percent, the price would have increased by over \$1 million.

In commenting on our draft report, Navy officials said the Chief of Naval Operations, Security Assistance Division, has been determining condition codes for fair value calculations, not only on the basis of Board of Inspection and Survey reports but also from inputs by Naval Sea Systems Command personnel, inputs from ship's custodian, actual on-site visits, or a combination of these. They also said that the Board determines a ship's material condition as well as its fitness to conduct prompt, sustained combat operations at sea. As part of the material assessment, the Board examines and evaluates the ship's engineering plant, hull integrity, and other non-weapon-related components. Other considerations go into the formula for fit/unfit, but the material condition of the ship is the predominant consideration.

The Navy is reviewing the manner in which condition codes for excess ships are established. One proposal is to have the appropriate Naval System Command evaluate and assign such condition codes, similar to the Navy's method of pricing other FMS items. This will be clarified in the forthcoming revision of Navy Instruction 4900.90D, scheduled to be issued March 30, 1984.

OVERHAULS NOT INCLUDED IN SELLING PRICE

The Navy sold two excess ships in 1982, which had overhauls completed within 24 months prior to their sale to foreign countries. These overhauls cost the Navy \$20.4 million. The foreign countries, however, were not charged for these overhauls as required by Navy instructions.

The Navy Comptroller Manual requires that overhaul costs be included in the selling price if an overhaul has been performed 24 months prior to the sale date. The Cone had an overhaul costing \$11.3 million which was completed in November 1980. This ship was sold in September 1982, 22 months later. Likewise, the Vogelgesang had an overhaul costing \$9.1 million which was completed in February 1980. This ship was sold in September 1981, 19 months later and transferred in February 1982. The foreign country was not charged for the overhaul cost in either instance.

In commenting on our draft report, Navy officials said these overhaul costs were not included through administrative error. To correct the possibility of such future errors, the instruction is being revised to provide specific guidance on overhaul dates and prices. The revision is scheduled to be issued on March 30, 1984.

Questionable policy for pricing overhaul costs

Currently, if a foreign country purchases a ship that was overhauled 24 months prior to the sale date, it is supposed to pay the full cost for the overhaul even though 2 years of the useful life of that overhaul has been exhausted. On the other hand, if a foreign country purchases a ship that was overhauled 25 months prior to the purchase date, it pays nothing for the remaining useful life of the overhaul. In calculating the sales price of a ship, we believe it would be appropriate to prorate any overhaul costs based on recommended intervals for overhaul.

Three of the 11 ships that we reviewed were overhauled between 24 and 30 months prior to their sale dates. For example, the Steinaker, which is a Gearing class destroyer with a recommended interval for overhauls of 37 months, was overhauled at a cost of \$9,179,737, 26.5 months prior to its sale date. The Navy followed its instructions and did not charge the foreign country for the overhaul. However, if the policy were to prorate overhaul costs, the price for the Steinaker would have increased by \$2.6 million. ($\$9,179,737 \div 37 \text{ months} = \$248,101 \text{ per month}$, multiplied by the 10.5 months remaining or \$2.6 million, if prorated)

If a policy of prorating overhaul costs were adopted, the time period over which overhaul costs would be prorated is longer for newer class ships because the interval between overhauls is greater.

In commenting on our draft report, Navy officials said this suggestion has been reviewed and Navy Instruction 4900.90D has been revised to insure clarity. This instruction is scheduled to be issued on March 30, 1984.

NAVY WAS NOT CHARGING
FOR ALL INCIDENTALS

The Navy was not reimbursed for over \$4.9 million in spare and repair parts transferred with ships sold to foreign countries in 1981 and 1982. In addition, indeterminate amounts of small arms, associated ammunition, and other items were transferred with these ships for which the Navy was not reimbursed. Part of the problem stems from a conflict in Naval instructions regarding whether a charge should be made. This conflict notwithstanding, we believe that in the future the Navy should be reimbursed for these incidentals.

Naval Material Instruction 4900.22 states that prices quoted for ships must include costs incidental to transfer, such as (1) pier services and utilities, (2) ammunition transferred to the customer country, (3) fuel on board at time of turnover, and (4) spare and repair parts on board at time of turnover. Conversely, Chief of Naval Operations Instruction 4900.90D allows for such things as fuel, repair parts, and spare parts to be transferred with a ship at no cost to the recipient country.

We found that when a foreign country requests that items such as spare and repair parts and fuel be added to a ship (as opposed to items already on board), the foreign country is charged. On the other hand, items left on board at the time of sale are transferred to the foreign country at no charge.

Based on our discussions with naval supply personnel, we estimate that for the 11 ships sold in 1981 and 1982 a total of \$4,912,503 in spare and repair parts was left on board and transferred to foreign countries at no cost. (See app. IV.) In some cases, the value of spare and repair parts exceeded the sale price of the ship. For example, the Steinaker was sold to Mexico for \$376,350 with an estimated \$575,000 worth of spare and repair parts.

Fuel is often left on board and transferred with the ship at no cost, particularly on hot ship transfers. In addition, small arms, associated ammunition, and consumables on board at

time of turnover are transferred without reimbursement. We were unable to determine the value of these items transferred with the 11 ships sold in 1981 and 1982 because records were not available.

In commenting on our draft report, Navy officials agreed that the cost of spare repair parts, fuel, ammunition, and equipment left on board at the time of sale should be recovered. The Navy has revised Naval Operations Instruction 4900.90D, which is scheduled to be issued March 30, 1984.

SELLING SHIPS UNDER SPECIFIC LEGISLATION

Sales of ships less than 20 years old or displacing more than 3,000 tons require specific congressional legislation. If that legislative language expressly conflicts with the Arms Export Control Act, the former controls. Some of the specific ship transfer statutes have provided only that the ship must be sold for a price not less than its "value." DOD has interpreted this provision without regard to valuation methods set forth in the Foreign Military Sales Financial Management Manual.

None of the ships sold in 1981 and 1982 required specific legislation. In 1980, however, 10 ships were sold under specific legislation. Eight of the ships were priced by the Navy at scrap value and the other two were priced on a fair value basis but at less than the lowest fair value rate of 5 percent. In three instances, the use of fair value would have resulted in a higher price. For example, the Paul Revere (LPA 248) was sold to Spain in January 1980 for \$1,200,000. Even if the lowest fair value of 5 percent had been used, the sale price would have increased to \$1,365,899. When requesting authorization from the Congress to sell ships under specific legislation, we generally believe the value of the ships disclosed to the Congress should be based on the higher of scrap or fair value.

CONCLUSIONS

The Navy's instructions for computing a ship's sale price are adequate in most cases but need to be followed more closely. There are some instances, however, where the instructions need to be revised.

The prices of ships sold to foreign countries under authority of Section 21 of the Arms Export Control Act were often understated because the Navy did not always follow its instructions. To the extent the sales prices were understated, the U.S. government provided about \$31.2 million in what is tantamount to grant military assistance to those countries. If the

Navy had correctly computed fair value for these sales, the prices would have totaled about \$36.4 million (consisting of \$20.4 million of overhaul costs, \$4.9 million of spare parts provided at no cost, and \$11.1 million in revenues lost because the fair value rate was not used) rather than the \$5.2 million actually charged. (See app. II.)

We recognize in certain instances that national security interests might justify selling a ship below its actual value. However, the decision to sell a ship at a lower price does not rest with the Navy. If the Navy proposes, for whatever reason, to charge a price less than the actual value of a ship as required by Section 21 of the Arms Export Control Act, it must request specific legislation authorizing such a lower price from the appropriate congressional committees. In addition, when the Navy requests specific authorization to sell a ship, we believe the proposed sale price it reports to the Congress should be based on the higher of scrap or fair value. If the Navy, however, proposes to sell the ship for less than this amount, the sale price, how it was calculated, and justification for that price should be reported. Congress then would have adequate information to determine what value it would require for the sale of the ship.

RECOMMENDATIONS

We recommend that you require that the Secretary of the Navy:

- Adhere to the established pricing instructions, which require pricing ships at the higher of fair value or scrap value. Specifically, when computing the sale prices for ships being sold to foreign countries, the Navy should include conversion costs to determine fair value.
- Provide the Congress, for ship sales which require specific legislation because they are less than 20 years old or over 3,000 tons, with information on (1) a proposed sale price based on the higher of scrap or fair value and (2) Navy proposals to sell a ship for less than this amount, how the amount was calculated and the justification for the proposed sale price.

In addition, we recommend that you direct the Secretary of the Navy to revise pricing guidance to require that:

- The Board of Inspection and Survey, in addition to determining whether a ship is fit or unfit for further U.S. Navy service, also determine

the ship's overall condition. The Chief of Naval Operations should use this determination in deciding what fair value rate to apply in computing the fair value price.

--Ship overall costs be prorated based on their recommended schedule for overhaul and such prorated costs be included in the sale price.

AGENCY COMMENTS AND OUR ANALYSIS

The Departments of Defense and State reviewed a draft of this report. The Deputy Director, Bureau of Politico-Military Affairs, Department of State, commented that although the Bureau works and coordinates very closely with the Navy on ship transfers, they did not believe it would be appropriate to comment on the report. (See app. V). We received official oral comments from DOD through the Defense Security Assistance Agency and Navy officials responsible for ship transfers. (Navy's written comments were received too late to be included in this report.) Defense agreed with some aspects of our report and said the Navy has taken some corrective actions and is revising instructions and reviewing others to determine if changes to policies are necessary. We have modified the draft report to (1) recognize that the Navy altered its pricing computations so that ships may be sold at the higher of scrap or fair value, and (2) clarify who determines the condition of ships. Other changes were proposed by the Navy and, where appropriate, are reflected in this final report.

Additionally, because of the actions taken by the Navy, we have deleted the proposed recommendations in the draft report (1) on updating the formula for determining scrap value, and (2) on including costs in the sale price for incidentals left on board and transferred with the ship.

DOD disagreed with our conclusion that if the Navy proposes to sell a ship 3,000 tons or less or 20 or more years old for less than its actual value, specific legislation authorizing the sale at the lower price must be requested. DOD stated that such actions are not necessary, since it is now DOD policy to sell ships for their actual value.

Additionally, DOD did not agree with our recommendation that Congress be provided with more pricing information for those ships requiring specific legislation to be sold (i.e., more than 3,000 tons or less than 20 years old). It stated that the procedures by which those ships are priced are already subject to hearings/review by four congressional committees. While the Navy has taken steps to improve the pricing of excess ships to ensure that the ships are sold at the higher of scrap or fair value, we continue to believe that the Navy, in seeking legislative authorization to sell a ship, should specifically disclose

to the Congress either that the proposed sales price is the higher of scrap or fair value or provide the rationale for the sales price.

OBJECTIVES, SCOPE, AND METHODOLOGY

Our review focused on the sale of excess ships to foreign countries and did not include leases since we recently issued a report on this subject.⁴ We examined the 11 ships sold to foreign countries in 1981 and 1982 to determine if the Navy followed its policies and procedures for selling these ships. We also obtained information on 10 ships sold under specific legislation during 1980, to determine how the Navy priced those ships.

We conducted our work primarily at the Department of the Navy in Washington, D.C. We reviewed correspondence relating to each ship sale; letters of congressional notification; letters of offer and acceptance; and appropriate policies, procedures, and instructions. This work included discussions with cognizant Navy officials. We visited naval bases in Philadelphia, Norfolk, and San Diego to verify information and get a better understanding of incidentals transferred, overhauls performed, and condition of the ships. We also made a walking tour of two excess Navy ships.

Our review was made in accordance with generally accepted government auditing standards.

⁴Defense Department's Management of Property Leased To Foreign Governments Is Still Inadequate, (GAO/ID-83-6, Nov. 23, 1983).

Estimated Price
Using Navy Instructions Versus
Actual Sale Price

(Column a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)
Excess Navy ships sold in 1961 and 1962	Acquisition cost	Conversion cost over life of ship	Fair value rate ^a	Fair value [(b-c)d]	Fair value plus FMS pricing elements ^b	Overhaul cost 24 months prior to sale	Estimated value of spare parts and operating space items ^c	Estimated price using Navy Instructions (F-g-h)	Actual sale price
Johnston (DD 821)	\$6,816,666	\$ 8,533,653	5%	\$ 887,516	\$ 912,266	-	\$ 203,389	\$ 1,115,655	\$ 286,000
M.K. Perry (DD 883)	8,144,019	9,371,216	5%	875,762	987,671	-	554,726	1,497,397	286,000
Cerry (DD 817)	8,816,668	12,662,295	5%	1,053,948	1,134,469	-	1,035,000	2,169,469	286,000
Dyess (DD 880)	8,144,019	10,218,916	5%	916,147	988,293	-	198,404	1,186,697	286,000
Rogers (DD 876)	8,144,019	10,926,747	5%	953,538	1,026,388	-	211,290	1,237,678	296,010
Steinaker (DD 863)	8,502,927	12,408,101	5%	1,045,551	1,125,431	-	574,895	1,700,326	376,350
Vogelgesang (DD 862)	8,502,927	10,513,981	5%	950,845	1,023,490	\$ 9,068,409	636,645	10,728,544	376,350
McLean (DD 704)	8,100,000	12,959,882	5%	1,052,994	1,133,443	-	289,962	1,423,405	357,410
Cone (DD 866)	8,500,000	10,503,568	5%	950,178	1,022,771	11,321,689	665,202	13,089,662	930,176
Hollister (DD 768)	8,100,000	7,475,138	5%	776,257	835,563	-	124,502	964,065	838,066
Hankins (DD 873)	8,100,000	9,846,544	5%	897,329	965,885	-	414,488	1,380,373	874,381
TOTAL					\$11,110,670	\$20,390,098	\$4,912,503	\$36,413,271	\$5,192,743

^a A 5-percent fair value rate is applied in each case. Documentation indicated, however, that some ships were in good condition and would probably warrant a higher rate. Pricing element is consist of: (a) 1/2 percent for nonrecurring research and development, (b) 3 percent for nonrecurring production costs, (c) 1 percent for asset use charge, and (d) 3-percent administration charge for expenses of sales negotiations, accounting, etc.

^b Value of these items is based on our estimates of the Coordinated Shipboard Allowance List Materials (COSAL) left on board and transferred with the ship. Based on discussions with Navy supply personnel, we determined the value by taking 50 percent of the value for operating space items when a ship was transferred the same day that it was decommissioned. Also included is 80 percent of the value for each ship's storeroom items (spares and repair parts).

Excess Navy Ships Sold
To Foreign Countries In
1981 and 1982

<u>Ship</u>	<u>Country</u>	<u>Sale date</u>	<u>Sale price</u>	<u>Year Navy acquired</u>	<u>Hot ship transfer</u>	<u>Notification or law</u>
Johnston (DD 821)	Taiwan	2-81	\$286,000	1946	No	Notification
N.K. Perry (DD 883)	Korea	2-81	286,000	1945	Yes	Notification
Corry (DD 817)	Greece	2-81	286,000	1946	Yes	Notification
Dyess (DD 880)	Greece	7-81	286,000	1945	No	Notification
Rogers (DD 876)	Korea	7-81	296,010	1945	No	Notification
Steinaker (DD 863)	Mexico	2-82	376,350	1945	Yes	Notification
Vogelgesang (DD 862)	Mexico	2-82	376,350	1945	Yes	Notification
McKean (DD 784)	Turkey	10-82	357,410	1945	No	Notification
Cone (DD 866)	Pakistan	10-82	930,176	1945	Yes	Notification
Hollister (DD 788)	Taiwan	12-82	838,066	1946	No	Notification
Hawkins (DD 873)	Taiwan	12-82	874,381	1945	No	Notification

APPENDIX IV

Estimated Value of Spare and Repair Parts And
Operating Space Items^a Left On Board Excess Navy
Ships Sold To Foreign Countries In 1961 and 1962

(Column a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)
Ship	Spare and repair parts	Percent ^b	Estimated value of spare and repair parts left on board (buc)	Operating space items (Applies only to to not ship transfers)	Percent ^b	Estimated value of operating space items left on board (est)	Estimated value of spare and repair parts and operating space items left on board (d-g)
Johnston (DD 821)	\$254,236	80%	\$203,369				\$ 203,369
W.M. Perry (DD 863)	360,750	80%	286,600	\$ 532,252	50%	266,126	554,726
Corry (DD 817)	621,598	80%	497,278	1,075,443	50%	537,722	1,035,000
Pyess (DD 860)	240,005	80%	190,404				190,404
Rogers (DD 876)	264,113	80%	211,290				211,290
Steinkor (DD 863)	370,263	80%	296,210	557,370	50%	278,685	574,895
Vogelgesang (DD 862)	415,855	80%	332,684	607,922	50%	303,961	636,645
McLean (DD 764)	362,452	80%	289,962				289,962
Cone (DD 866)	436,627	80%	349,302	631,800	50%	315,900	665,202
Hullister (DD 788)	160,627	80%	128,502				128,502
Hankins (DD 873)	518,110	80%	414,488				414,488
Total							\$4,912,503

^aOperating space items are parts which are stored with operating equipment rather than in designated storerooms.
^bSee app. II, footnote C.

APPENDIX IV

APPENDIX V



DEPARTMENT OF STATE
Comptroller
Washington, D.C. 20520

APPENDIX V

7 SEP 1983

Dear Frank:

I am replying to your letter of August 8, 1983, which forwarded copies of the draft report: "Excess Navy Ships are Being Sold to Foreign Countries at Understated Prices."

The enclosed comments on this report were prepared by the Deputy Director in the Bureau of Politico-Military Affairs.

We appreciate having had the opportunity to review and comment on the draft report. If I may be of further assistance, I trust you will let me know.

Sincerely,

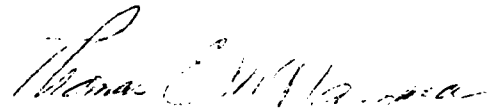
Rogers
Roger B. Feldman

Enclosure:
As stated.

Mr. Frank C. Conahan,
Director,
National Security and
International Affairs Division,
U.S. General Accounting Office,
Washington, D.C. 20548

GAO DRAFT REPORT: Excess Navy Ships are Being Sold to Foreign Countries at Understated Prices

The Bureau of Politico-Military Affairs works and coordinates very closely with the Navy on ship transfers to foreign countries. The GAO report, however, is confined to reviewing and making recommendations on Navy Department instructions, policy and practice related to price determinations in the ship transfer process. As this is strictly an internal Navy Department matter, it would not be appropriate for the State Department to comment on either the report or its recommendations.



Thomas E. McNamara
Deputy Director
Bureau of Politico-Military Affairs

END

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